

**ANALYSIS OF ORIGINAL BILL**

Author: Niello/Garcia Analyst: Scott McFarlane Bill Number: AB 1918  
 Related Bills: SB 1055 (2007/2008) Telephone: 845-6075 Introduced Date: February 8, 2008  
 Attorney: Doug Powers Sponsor: \_\_\_\_\_

**SUBJECT:** Mortgage Forgiveness Debt Relief

**SUMMARY**

This bill would generally conform California law to the recently-enacted federal Mortgage Forgiveness Debt Relief Act of 2007, which generally provides for an exclusion from gross income, up to a maximum of \$2 million, for qualified debt forgiveness on a principal residence.

**PURPOSE OF THE BILL**

According to the author's office, the purpose of this bill is to provide state income tax relief to already distressed homeowners.

**EFFECTIVE/OPERATIVE DATE**

As a tax levy, this bill would be effective immediately and would be operative January 1, 2007.

**POSITION**

Pending.

**SUMMARY OF SUGGESTED AMENDMENTS**

This bill would provide an income exclusion for discharges occurring in taxable year 2007, which may be considered to constitute a gift of public funds within the meaning of Section 6 of Article XVI of the California Constitution. Amendments 1 and 2 are suggested to provide public purpose language.

**BACKGROUND****Cancellation of Debt (COD)**

If a taxpayer borrows money from a commercial lender and the lender later cancels ("forgives") the debt, the taxpayer may have to include the cancelled amount in income for tax purposes. When the taxpayer borrowed the money, the loan proceeds were not required to be included in income because the taxpayer had an obligation to repay the lender.

Board Position:

\_\_\_\_\_ S      \_\_\_\_\_ NA      \_\_\_\_\_ NP  
 \_\_\_\_\_ SA      \_\_\_\_\_ O      \_\_\_\_\_ NAR  
 \_\_\_\_\_ N      \_\_\_\_\_ OUA        X   PENDING

Department Director

Date

Selvi Stanislaus

3/5/08

When that obligation is subsequently forgiven, the amount received as loan proceeds is reportable as income because there is no longer an obligation to repay the lender. The lender is usually required to report the amount of COD to the taxpayer and the IRS on a Form 1099-C, Cancellation of Debt.

Example: A taxpayer borrows \$10,000 and defaults on the loan after paying back \$2,000. If the lender is unable to collect the remaining debt, there is a cancellation of debt of \$8,000, which generally is taxable income.

### ***When COD Income is Taxable***

While COD income is generally includable as taxable income, there are some exceptions:

- Bankruptcy: Debts discharged through bankruptcy are not considered taxable income.
- Insolvency: If a taxpayer is insolvent when the debt is cancelled, some or all of the cancelled debt may not be taxable. A taxpayer is insolvent when the taxpayer's total debts are more than the fair market value of the taxpayer's total assets.
- Certain farm debts.
- Non-recourse loans: A non-recourse loan is a loan for which the lender's only remedy in case of default is to repossess the property being financed or used as collateral. That is, the lender cannot pursue the homeowner personally in case of default. Forgiveness of a non-recourse loan resulting from a foreclosure does not result in COD income. However, it may result in other tax consequences, such as capital gain.

*Note:* Section 580b of the California Code of Civil Procedure provides that indebtedness incurred to purchase a home in California is non-recourse debt. Therefore, in general, first mortgages in California are non-recourse debt. If a California homeowner refinances that debt, or takes out a home equity loan, the refinanced indebtedness or the home equity loan is generally recourse debt.

A discussion of the tax consequences of a home foreclosure is provided in the attached Appendix.

## **ANALYSIS**

### **FEDERAL/STATE LAW**

#### **Federal Law**

Gross income includes income that is realized by a debtor from the discharge of indebtedness, subject to certain exceptions for debtors in Title 11 bankruptcy cases, insolvent debtors, certain student loans, certain farm indebtedness, and certain real property business indebtedness (Internal Revenue Code (IRC) sections 61(a)(12) and 108). In cases involving discharges of indebtedness that are excluded from gross income under the exceptions to the general rule, taxpayers generally reduce certain tax attributes, including basis in property, by the amount of the discharge of indebtedness.

The amount of discharge of indebtedness excluded from income by an insolvent debtor not in a Title 11 bankruptcy case cannot exceed the amount by which the debtor is insolvent. In the case of a discharge in bankruptcy or where the debtor is insolvent, any reduction in basis may not exceed the excess of the aggregate bases of properties held by the taxpayer immediately after the discharge over the aggregate of the liabilities immediately after the discharge (IRC section 1017).

For all taxpayers, the amount of discharge of indebtedness generally is equal to the difference between the adjusted issue price of the debt being cancelled and the amount used to satisfy the debt. For example, assume a taxpayer who is not in bankruptcy and is solvent owns a principal residence subject to a \$200,000 mortgage debt. If the creditor forecloses and the home is sold for \$180,000 in satisfaction of the debt, the debtor has \$20,000 of income from the discharge of indebtedness.

**THE MORTGAGE FORGIVENESS DEBT RELIEF ACT OF 2007 (P.L. 110-142), enacted December 20, 2007**

The Mortgage Forgiveness Debt Relief Act of 2007 (the Act) excludes from the gross income of a taxpayer any discharge of indebtedness income by reason of a discharge of qualified principal residence indebtedness occurring on or after January 1, 2007, and before January 1, 2010. Qualified principal residence indebtedness means acquisition indebtedness (within the meaning of IRC section 163(h)(3)(B)), up to \$2,000,000. Acquisition indebtedness with respect to a principal residence generally means indebtedness incurred in the acquisition, construction, or substantial improvement of the principal residence of the individual and secured by the residence. It also includes refinancing of such debt to the extent the amount of the refinancing does not exceed the amount of the indebtedness being refinanced.<sup>1</sup>

If, immediately before the discharge, only a portion of a discharged indebtedness is qualified principal residence indebtedness, the exclusion applies only to so much of the amount discharged as exceeds the portion of the debt that is not qualified principal residence indebtedness. Thus, assume that a principal residence is secured by an indebtedness of \$1 million, of which \$800,000 is qualified principal residence indebtedness. If the residence is sold for \$700,000 and \$300,000 debt is discharged, then only \$100,000 of the amount discharged may be excluded from gross income under this provision.

The individual's adjusted basis in their principal residence is reduced by the amount excluded from income under the Act. Under the Act, the exclusion does not apply to a taxpayer in a Title 11 case; instead, the Title 11 exclusion applies. In the case of an insolvent taxpayer not in a Title 11 case, the exclusion under the Act applies unless the taxpayer elects to have the insolvency exclusion apply.

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<sup>1</sup> The term "principal residence" has the same meaning as when used in IRC section 121. (IRC section 121 provides a \$250,000 exclusion (\$500,000 for married taxpayers filing a joint return) on the gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence for periods aggregating 2 years or more. Refer to federal Treasury Regulation section 1.121-1 for the facts and circumstances used to determine "principal residence.")

## State Law

Currently, California does not conform to the Mortgage Forgiveness Debt Relief Act of 2007.

The California personal income tax return starts with federal adjusted gross income (AGI) and requires adjustments to be made for differences between federal and California law. An adjustment relating to the income from the discharge of qualified principal residence indebtedness is required under current law. A taxpayer excluding income from the discharge of qualified principal residence indebtedness on the federal individual income tax return is required to increase AGI on the taxpayer's California personal income tax return by the amount of the federal exclusion.

## THIS BILL

This bill would conform to the federal Act by allowing an income exclusion of up to \$2 million of COD income generated from the discharge of qualified principal residence indebtedness. The exclusion would apply to discharges occurring on or after January 1, 2007 and before January 1, 2010.

## TECHNICAL CONSIDERATIONS

This bill would provide an income exclusion for discharges occurring in taxable year 2007, which may be considered to constitute a gift of public funds within the meaning of Section 6 of Article XVI of the California Constitution. Amendments 1 and 2 have been suggested to provide public purpose language.

## **LEGISLATIVE HISTORY**

SB 1055 (Machado/Correa, 2007/2008) is similar to this bill except that it applies to discharges occurring on or after January 1, 2007 and before January 1, 2009. That bill is currently at the Senate Appropriations Committee.

## **OTHER STATES' INFORMATION**

The states surveyed include *Florida*, *Illinois*, *Massachusetts*, *Michigan*, *Minnesota*, and *New York*. These states were selected due to their similarities to California's economy, business entity types, and tax laws. *Florida* does not impose a personal income tax, therefore a comparison to *Florida* is not relevant.

*Michigan*, *New York*, and *Illinois* automatically conform each taxable year to the IRC. Accordingly, these states conform to the federal Mortgage Forgiveness Debt Relief Act of 2007, and the exclusion provided by that Act is applicable.

*Minnesota* and *Massachusetts* conform to the IRC as of a specified date, similar to California. *Minnesota* conforms to the IRC as amended through May 18, 2006; *Massachusetts* conforms to the IRC as of January 1, 2005. Additional legislation would be needed for these states to be in conformity with the federal Act.

## **FISCAL IMPACT**

The bill would not significantly impact the department's costs.

## **ECONOMIC IMPACT**

### Revenue Estimate

Based on data and assumptions discussed below, this bill would result in the following revenue losses:

Estimated Revenue Impact of AB 1918 as Introduced 02/08/2008 Effective for Tax Years 2007, 2008 and 2009 Enactment Assumed After 6/30/2008 (\$ in Millions)		
2008-09	2009-10	2010-11
-\$13	-\$10	-\$2

Of the \$13 million loss for 2008/09, \$5 million is accrued back one year to 2007/08 because the bill impacts mortgage debts discharged during 2007.

The estimated number of California taxpayers that will be impacted by this bill is 14,800 (3,000, 5,300, and 6,500 for 2007, 2008, and 2009, respectively).

### Revenue Discussion

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

The revenue impact of this bill would be determined by the amount of qualified principal residence indebtedness discharged and the marginal tax rate of taxpayers otherwise including COD in gross income.

The revenue loss was estimated as follows. Federal estimates by the Joint Committee on Taxation were converted to liability (tax) year estimates (\$117 million, \$200 million and \$261 million for fiscal years 2007, 2008 and 2009, respectively). The federal liability amount was prorated to California using a proration factor of 4.2%. This proration factor was calculated using four factors: (1) the ratio of California foreclosure to foreclosures nationally using data from RealtyTrac (22%); (2) the ratio of median house price in California to median price nationally (145%), calculated using data from National Association of Realtors and California Association of Realtors; (3) the ratio of qualified taxpayers in California to qualified taxpayers nationally (43%), which was calculated based on assumed differences in percentage of foreclosures involving insolvency, non-recourse loans and non-qualified recourse loans; and (4) the California average marginal tax rate as a percent of the federal average marginal tax rate (31%).

The calculation for the 4.2% proration factor is:  $0.042 \approx 0.22 \times 1.45 \times 0.43 \times 0.31$

The revenue loss for 2007 is \$4.9 million ( $0.042 \times \$117$  million); for 2008, it is \$8.4 million ( $0.042 \times \$200$  million); and for 2009, it is \$11 million ( $0.042 \times \$261$  million).

Taxable year estimates are converted to fiscal year estimates in the table above.

## **LEGISLATIVE STAFF CONTACT**

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## Appendix

### **Tax Consequences of a Home Foreclosure**

When a taxpayer loses a home through foreclosure, there are two possible tax consequences:

- Taxable COD income. (Note: As stated above, forgiveness of a non-recourse debt does not result in COD income.)
- A reportable gain from the disposition of the home (because foreclosures are treated like sales for tax purposes). (Note: Often some or all of the gain from the sale of a personal residence qualifies for exclusion from income.)

The following steps illustrate how to compute the income to be reported from a foreclosure:

Step 1 - Figuring COD Income (Note: For non-recourse loans, skip this step. There is no COD income.)

1. Enter the total amount of the debt immediately prior to the foreclosure. \_\_\_\_\_
2. Enter the fair market value of the property on the date of foreclosure. \_\_\_\_\_
3. Subtract line 2 from line 1. If less than zero, enter zero. \_\_\_\_\_

The amount on line 3 is taxable COD income, unless one of the exceptions applies.

#### Step 2 – Figuring Gain from Foreclosure

4. Enter the fair market value of the property foreclosed. For non-recourse loans, enter the amount of the debt immediately prior to the foreclosure. \_\_\_\_\_
5. Enter the adjusted basis in the property. (Usually the purchase price plus the cost of any major improvements.) \_\_\_\_\_
6. Subtract line 5 from line 4. If less than zero, enter zero. \_\_\_\_\_

The amount on line 6 is the gain from the foreclosure of the home. If a taxpayer has owned and used the home as a principal residence for periods totaling at least two years during the five year period ending on the date of the foreclosure, the taxpayer may generally be able to exclude up to \$250,000 (up to \$500,000 for married couples filing a joint return) from income. If the taxpayer does not qualify for this exclusion, or the gain exceeds \$250,000 (\$500,000 for married couples filing a joint return), that portion that does not qualify for the exclusion or exceeds the \$250,000/\$500,000 exclusion limitation is included in income as a capital gain.

More information is provided on the IRS Web site:

<http://www.irs.gov/newsroom/article/0,,id=174034,00.html>

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 1918  
As Introduced February 8, 2008

AMENDMENT 1

On page 3, after line 24, insert:

SEC. 2. The Legislature finds and declares that the mortgage debt tax relief allowed to taxpayers in connection with the discharge of qualified principal residence indebtedness, as described in this act, serves a public purpose and does not constitute a gift of public funds within the meaning of Section 6 of Article XVI of the California Constitution.

AMENDMENT 2

On page 3, line 25, strikeout "SEC. 2." and insert:

SEC. 3.